

**Focus Note No. 16, May 2000**

### **Those Who Leave and Those Who Don't Join: Insights from East African Microfinance Institutions**

Understanding client exit and non-participation can shed important light on the financial service preferences of clients and help programs learn about the limitations of their existing products and mechanisms. Such lessons can drive the development of innovative, demand-driven microfinance products and systems, benefiting both the institution and the clients.

*MicroSave-Africa*, a joint UNDP/DFID project based in Kampala, Uganda, studied 13 microfinance institutions (MFIs) in East Africa to address the "who and why" questions of exit and non-participation. This problem is of particular importance in East Africa for two reasons:

- First, high dropout rates ranging from 13 to 60 percent per year plague the region's microfinance industry.
- Second, such high levels of client exit are adversely affecting the scale of outreach. It falls far below market potential—for instance, coverage equals less than 1 percent of the target population in Tanzania and not much more in Kenya. There are now more MFI dropouts in East Africa than there are active clients!

#### **Those Who Leave**

Conceptually, it is possible to distinguish between voluntary dropouts and those forced to drop out, either by peer members and/or staff. In practice, it is often difficult to isolate a specific factor in the dropout process since often both voluntary and coercive mechanisms are involved. Dropping out from one MFI, however, might not result in withdrawing from MFI services entirely. Many clients drop out to "rest" during periods of economic and business downturn while some transfer to other service providers where available.

Different MFIs use different definitions for dropouts. In the credit-driven East African context, many MFIs consider those who do not have outstanding loans to have dropped out, even if they retain savings with the MFI. For many clients, however, not taking out a loan but retaining the option to do so could well be an important risk management strategy. Some MFIs do not permit this behavior and "balance out" (i.e. savings are returned or balanced with outstanding loan payments) clients who do not immediately take a repeat loan. Faced with risk and uncertainty, using savings and "resting", rather than taking out a fresh new loan, might be the preferred strategy for many clients. Restricted access to savings combined with not allowing "resting" can be costly for clients and lead to unnecessary exits (see Box 1). A minority of MFIs adopt a less severe credit-driven approach and only count a client as a dropout when s/he closes both loan and savings accounts. These differences in the definition of dropout make comparison across MFIs difficult.

### Box 1: Dropout in a Dynamic Context: Resting and Transferring

Josephine is a successful retail trader in vegetables at Nyeri market in Kenya. She kept her savings in a commercial bank but heard of K-REP and joined in 1993 with the aim of improving her business and making more profit by buying in bulk. In 1996, disaster struck. She fell ill and needed medical treatment and her business suffered. She "balanced out" her loan with her savings and left the group. In 1997, she was fit again and joined another MFI in Nyeri. She took one loan from this MFI but soon left as she did not like the way the MFI held savings. She has now pulled together another group and has arranged for them to join K-REP in the next few weeks.

The lack of data makes it difficult to generalize about the patterns of dropout over time. Nevertheless, based on qualitative information from the MFIs studied, a number of common experiences seem to emerge:

- Dropout rates increase when there is a downturn in the national economy and/or adverse climatic conditions for agriculture.
- Most solidarity-group-based MFIs report significant numbers of dropouts during the initial period of member training. Some also experience many dropouts after the first few loan cycles. This is due to two factors: "product testing" by clients and "weeding-out" by MFIs. Typically, dropout incidence also tends to rise during the later loan cycles; this, however, arises primarily from clients facing problems with higher weekly repayments as loan size increases without a corresponding extension of the loan repayment term.
- Most field staff can identify periods in which dropout rates are higher: typical "problem times" are religious festivals (Christmas, Eid, etc.), the period before harvest, and the time for payment of school fees.
- Most MFIs have experienced at least one major "shake-out" when changes in policies have led to the rapid exit of a large number of clients.
- A number of MFIs have experienced increased dropouts because of management problems, such as fraud, or cash flow difficulties that prevented the MFI from disbursing promised loans to clients on time.

### Poverty and Dropouts

The incidence of dropouts remains remarkably constant among different wealth groups as measured by land ownership or educational levels (see Table 1). This is also true for gender and age distinctions. However, the *reasons* why clients decide to drop out vary greatly between different socio-economic groups.

**Table 1: Recruitment and dropout of PRIDE Tanzania, Arusha Branch**

| Landholding            | Clients recruited as % of total | Clients dropped out as % of total |
|------------------------|---------------------------------|-----------------------------------|
| Own no land            | 75                              | 72                                |
| Own less than .5 acre  | 4                               | 4                                 |
| Own .5 to 1 acre       | 6                               | 6                                 |
| Own 1 to 2 acres       | 7                               | 8                                 |
| Own 2 to 5 acres       | 6                               | 7                                 |
| Own 5 to 10 acres      | 2                               | 2                                 |
| Own more than 10 acres | 1                               | 1                                 |

Poorer clients tend to drop out when the average size of loans within the joint liability group rises to high levels and they take the risk of guaranteeing much larger loans than they themselves can take (see Box 2). In addition,

poorer clients are particularly vulnerable to the increasing size of weekly repayment installments. Such "program-design-induced" risk, when coupled with the general vulnerability to economic downturns faced by the poor, leads to dropout.

### **Box 2: K-REP: Drifting Up and Shifting Down**

In the mid 1990s K-REP allowed its clients to rapidly expand their loans by a policy of automatically doubling the loan size for those who repaid on schedule. This encouraged relatively wealthier people to join and, after a few cycles, take out loans of KSh.200,000 to KSh.500,000 (US\$3,200 to US\$8,000). Poorer group members began to drop out as they were concerned about guaranteeing such big loans, and K-REP's clientele "drifted up". Just as bad, some tricksters joined, took a series of loans that they rapidly repaid, then defaulted or disappeared once they had a large loan.

To reduce exit rates and refocus on its target group, K-REP changed its policy on loan size. In some of the K-REP groups we visited, clients reported that wealthier clients were dropping out now as they could not rapidly develop a credit record that would give them access to large loans.

This experience illustrates the ways in which product design influences client bases and dropout structures.

By contrast, wealthier clients of MFIs also show a propensity to drop out. The main reasons for this are

- the desire for larger loans as the maximum loans given by MFIs are too small for their growing businesses;
- annoyance at having anticipated loans delayed because of other group members being in arrears; and,
- frustration with the amount of time spent in group meetings and in trying to recruit new members to replace dropouts. As a Kampala shopkeeper told us "...meeting time is killing my business."

These factors commonly lead to wealthier members exploring the possibility of transferring to an MFI that offers larger loans, or joining two MFIs at the same time, or joining a bank that can offer larger loans on an individual basis (as Centenary Bank is now doing in Uganda). In addition, wealthier clients can take advantage of ROSCAs, in cases where the core group membership is relatively wealthy and require large weekly contributions. Pay-outs from these ROSCAs are substantial--enough to partially capitalize a rapidly growing business and make up for the limited size of the MFI loan!

The general conclusion that emerges from this study is that the products of most East African MFIs are aimed at "average clients" operating in "normal times". However, when average clients do well or, conversely, do badly and slip into poverty, the lack of flexibility in the products makes them less attractive. To quote from the study, "to a significant degree, the present products of MFIs in East Africa provide clients with high levels of incentives to dropout."

### **Those Who Don't Join**

The degree of market penetration when contrasted to the potential market coverage (the market defined either by the number of informal enterprises or the number of poor) of East African MFIs is pretty low. Out of an estimated 4 million informal enterprises in Tanzania, there are less than 40,000 MFI clients. In Kenya, which has the region's most developed sector, MFIs outside the credit union system reach 3.5 percent of the country's poor at

best. This lack of outreach stems from the absence of appropriate products *and* of a delivery model capable of providing quality financial services to a significant proportion of the financially excluded population at an acceptable cost. The *MicroSave-Africa* study highlights problems with "imported" models and products, and argues that a lot of creative rethinking and innovation remain to be done.

The *MicroSave-Africa* researchers identified the wealth categories from which most of the MFI clients came, based on extensive interviews with staff, clients, dropouts, and non-clients (see Figure 1). The results for the MFIs studied strongly suggest that clients tend to cluster around the poverty line. Most clients of the MFIs studied appear to be non-poor, but not wealthy: they tend to come largely from households that can meet their daily needs, have access to primary education and basic health services, and have accumulated some assets. This group of clients are in the "comfort zone"; they enjoy a relatively stable income source and sufficient livelihood diversification, allowing them to service regular repayments even when faced with small crises. They remain vulnerable to shocks, however, and access to microfinance services plays an important role in managing this vulnerability.

**Figure1: Who do they reach?**

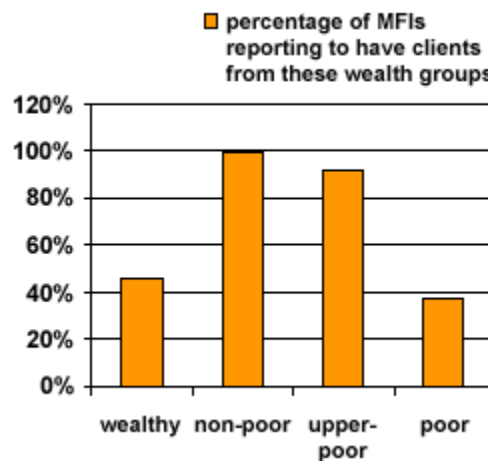


Figure 1 indicates that the poor, or those significantly below the poverty line, do not join East African MFIs. This occurs for several reasons, including:

- exclusion by the MFIs themselves due to their focus on microentrepreneurs with sufficient repayment capacity;
- exclusion by groups unwilling to take responsibility for the poor in case of delinquency;
- self-exclusion due to a fear of credit; and,
- product exclusion where the "one-size-fits-all" working capital loan on offer does not meet their needs.

## Conclusion

In sum, the present products of MFIs in East Africa explain the high rates of dropout and low outreach. The industry has adopted a small number of very similar "imported" ideas without adequate local experimentation and understanding of the financial service preferences of the clients.

The *MicroSave-Africa* study highlights the importance of designing more flexible, demand-driven products to address the financial service needs of

the poor and attain significant outreach in the region. The first step entails gaining a better appreciation of the market, and the household finances and money management of clients. Institutions should also systematically collect information on client exit with a view to understanding the limitations of existing products and generating ideas for future product development. However, the study also raises a number of issues, including:

- What is the effect of client dropout on MFI performance? What is the cost of dropouts, both for clients and institutions?
- What is the best definition of dropout? Can measurement of dropouts be standardized to facilitate benchmarking and cross comparisons?
- How can MFIs implement effective policies and procedures for tracking dropouts?
- How can MFIs use information about dropouts to design new products?

(This note is based on a research by Leonard Mutesasira, Henry Sempangi, Harry Mugwanga, John Kashangaki, Florence Maximambali, Christopher Lwogs, David Hulme, Graham Wright and Stuart Rutherford. It was prepared by Imran Matin and Brigit Helms of the CGAP Secretariat.)